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ABSTRACT

This paper examines the shortcomings of the existing federal system for providing student financial aid and evaluates the use of tuition tax credits and expanded Individual Retirement Accounts (IRAs) two of the largest educational provisions contained in the Balanced Budget Act of 1997. It finds that tuition is continuing to rise, college affordability is declining, and the participation gap between low- and high-income students is widening. It identifies three reasons for these trends: (1) colleges have little incentive to control costs and tuition; (2) the market for higher education is distorted; and (3) middlemen receive much of the benefit from federal subsidies. Analysis of the HOPE Scholarship, a tuition tax-credit program, suggests that many institutions may raise their prices to absorb the additional revenue, that the program will not help students from very low-income families, that benefits will accrue to institutions of higher education rather than to students, and that some middle class families claiming the credit may become subject to the alternative minimum tax. The paper concludes that expansion of IRAs would be preferred because families will be encouraged to save for educational expenses, government aid can be diverted to need-based programs for the poor, tuition inflation will be controlled by restoring competition among colleges and universities, and families will make more responsible decisions that maximize their children's educational return. (DB)

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COLLEGE AFFORDABILITY: TUITION TAX CREDITS VS. SAVING INCENTIVES

A JOINT ECONOMIC COMMITTEE STUDY

Jim Saxton (R-NJ), Chairman

Joint Economic Committee
United States Congress

October 1997

Abstract

Despite government efforts to improve college affordability over the years, it is now clear that federal aid programs have fallen short of their expectations: tuition continues to rise, more students graduate with larger debts, government costs have grown dramatically, and affordability for the neediest students has declined. This paper examines the shortcomings of the federal aid system that have contributed to these trends and considers the most effective federal policies to expand educational opportunities. In particular, it considers the use of tuition tax credits and expanded Individual Retirement Accounts, two of the largest educational provisions contained in the Balanced Budget Act of 1997.

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COLLEGE AFFORDABILITY: TUITION TAX CREDITS vs. SAVING INCENTIVES

EXECUTIVE SUMMARY

Education is an important means of investing in human capital. Accordingly, the government has played an active role in financing higher education in order to provide universal access to college. Despite government efforts to improve college affordability, federal aid programs have fallen short of their expectations.

- **Tuition continues to rise.** The price of higher education has nearly doubled over the past 15 years and continues to rise. The average annual cost of attending private and public institutions in 1995 was $17,000 and $6,000, respectively, when room and board were included.

- **College affordability is declining.** Despite a 65 percent increase in government funding over the past 10 years, college affordability is declining. As the cost of the student loan programs continues to grow, more funding is being shifted toward loans for middle- and upper-income families, leaving less money to finance grants and other need-based programs for the poor. As a result, grants as a percentage of all federal aid have fallen by 36 percent, and educational opportunities for the poor have declined. The channeling of funds toward student loans does not necessarily reflect an increase in the well being of middle- and upper-income families since tuition increased by approximately 45 percent over the past 10 years, offsetting much of the benefits of the increased funding. Overall, the federal aid system is heavily dependent on student debt, even for the most disadvantaged families

- **The participation gap between low- and high-income students is widening.** The prospect of incurring large debts has discouraged many low-income students from attending college altogether. As a result, the participation gap between low- and high-income students has increased by 22 percent since 1980.

These trends have occurred for several reasons.

- **Colleges have little incentive to control costs and tuition.** By increasing the availability of federal aid, the government increases the stream of revenue available to colleges, thus encouraging them to raise costs and justify tuition hikes. Colleges thus largely absorb increased funding.

- **The market for higher education is distorted.** The structure of federal aid allows private institutions to price discriminate so that colleges can extract the maximum amount of revenue from each student and raise their prices above the competitive level.

- **Middlemen receive much of the benefit from federal subsidies.** In 1992, 6 million students received some form of federal aid costing taxpayers $11 billion. Of this amount, $6 billion represented the cost of subsidizing financial institutions and student loan defaults. Thus students do not receive the full economic benefit of federal aid and taxpayers finance a wasteful system.

Families would benefit from alternative federal aid policies that provide more benefits to more students at a lower cost. The Balanced Budget Act of 1997 provides several tax benefits to expand educational opportunities. Two of the largest are tuition tax credits, called HOPE Scholarships, and expanded benefits for Individual Retirement Accounts (IRAs).

HOPE Scholarship

The use of tuition tax credits is similar to past government policies that have merely increased the amount of aid available to families without addressing the underlying problems of the federal aid system that cause tuition to rise in the first place. As a result, tuition tax credits may well contribute to the problems of the federal aid system instead of improving college affordability.

- There is broad agreement that the HOPE Scholarship will lead many institutions to raise their prices in order to absorb the additional stream of revenue.

- Since the HOPE Scholarship is designed to primarily benefit middle- and high-income families, it will not provide new educational opportunities for children in the poorest families.

- In the short run, the HOPE Scholarship will allow some families to send their children to more expensive schools and it may reduce the amount of financial aid for which many families qualify. In the long run, the benefits will accrue to institutions of higher education rather than to students.

- Claiming the HOPE Scholarship may subject many middle-income families to the alternative minimum tax (AMT), which was designed to only affect upper-income taxpayers. Thus families with incomes as low as $41,350 may not receive the full benefit of the credit, even in the short run.

Expanded IRAs

The Balanced Budget Act of 1997 provides several education saving incentives through the expansion of traditional IRAs and the creation of education saving accounts similar to IRAs. Saving incentives can improve college affordability for families across the income spectrum.

- Expanded IRAs provide families with appropriate opportunities and incentives to save for their children's higher educational expenses, thereby reducing their reliance on student loans. As families become financially independent, the cost and size of the student loan programs will be reduced since demand for student loans will fall.

- Government savings can be diverted to grants and other need-based programs for the poor.

- Expanded IRAs can control tuition inflation by restoring competition to the market for higher education. Colleges and universities will have an incentive to control costs and improve productivity since they will be more reliant on private financial assets than on federal subsidies.

- Families that use their own financial assets to pay for higher education will be motivated to make more responsible decisions regarding where their children go to school and what programs they enter, thus maximizing their children's educational return.

Although the newly enacted IRA provisions provide important benefits for higher education, a more aggressive expansion of IRAs would provide greater benefits to families. If the maximum annual deductible contribution is raised and penalty-free withdrawals are allowed for more family expenses, IRAs can become an important saving vehicle for middle-income families. Aside from the tax benefits provided to families, expanded IRAs can also promote economic growth by potentially raising the national saving rate.

Representative Jim Saxton (R-NJ), Chairman
Joint Economic Committee

COLLEGE AFFORDABILITY: TUITION TAX CREDITS vs. SAVING INCENTIVES

In the 1960s, Nobel Laureate Gary Becker introduced the concept of human capital—the widely accepted notion that human qualities such as skills, knowledge, and the ability to think critically are important sources of economic growth. Education is a primary means of investment in human capital. Education helps individuals develop abilities and skills that increase their future productivity, thereby providing new opportunities for economic growth. It is also the primary vehicle by which cultural values are conveyed from one generation to the next.

Because education is so important to individuals and to the economy, the government has played an active role in financing higher education so that all individuals can have an opportunity to attend college. Initially, federal aid was limited to the most disadvantaged students, but over time, aid was extended to most students regardless of financial need or academic merit. Despite the government's efforts to improve college affordability, it is now clear that federal aid programs have fallen short of their expectations: tuition continues to rise, more students graduate with larger debts, government costs have grown dramatically, and affordability for the neediest students has declined.

This paper reviews the shortcomings of the federal aid system and examines the most effective policies to expand educational opportunities. In particular, it considers the use of tuition tax credits and expanded Individual Retirement Accounts (IRAs), two of the largest educational provisions contained in the Balanced Budget Act of 1997.

The evidence presented in the paper suggests that tuition tax credits may well contribute to the problems of the federal aid system. In contrast, expanded IRAs can provide long-term solutions to college affordability by providing families with appropriate incentives and opportunities to save for their children's education. The use of IRA savings for college education will encourage schools to control costs, lower tuition, and improve quality since they will have to compete for private financial assets rather than rely on federal subsidies. The expansion of IRAs can also generate additional benefits for families and can promote economic growth by raising the national saving rate.

The first section of this paper describes the role of the federal government in higher education and recent trends in college affordability. Section two considers some of the fundamental shortcomings of the federal aid system that have caused these trends. Section three compares the use of tuition tax credits and expanded IRAs in light of the problems discussed throughout the paper. The paper concludes by discussing additional economic benefits of IRAs.

I. THE ROLE OF THE FEDERAL GOVERNMENT

Background[1]

Historically, the federal government played a very small role in higher education. It did not regulate the activities of post-secondary institutions nor did it provide them with federal funds. However, the Higher Education Act (HEA) of 1965 established a commitment by the federal government to equalize opportunities in higher education. Title IV of HEA created grants and campus-based programs for disadvantaged students and their families. Title IV also helped middle-income students through the creation of federally guaranteed, but minimally subsidized, private loans. The guaranteed loan program was supposed to be smaller and much less costly than federal grants.

During the 1970s, various legislation expanded the provisions of Title IV. The needs test for guaranteed loans was eliminated, making federal aid widely available to students across the income spectrum. Federal aid was also extended to non-traditional students such as part-time students, students attending for-profit trade schools, and students without high school diplomas or equivalency.

The growth of the student loan programs during the 1970s created mounting costs for the government as more middle- and upper-income families took advantage of the generous terms offered by subsidized loans. Between 1970 and 1980, the cost of guaranteed student loans increased by 180 percent after adjusting for inflation, from $3.9 billion to $10.9 billion annually.[2] Realizing that these growing costs were unsustainable, efforts were made in the 1980s to reduce the size of the student aid programs by focusing federal support on the neediest families. Although the needs test for subsidized loans was reinstated, other cost-reducing efforts were derailed in Congress and federal support remained steady throughout most of the 1980s.

Legislation in the early 1990s continued to expand the availability of student loans so that nearly anyone wanting to attend college could take out a loan for the full amount. As students began graduating with larger debts and default rates began rising, new provisions were enacted to facilitate loan repayment. In 1995, student aid from the federal government totaled $37 billion, an amount equal to 74 percent of all student aid funding.[3]

Trends in College Affordability

Many education analysts believe that past legislation has not made college more affordable, it has simply made it easier to take out loans, thus increasing families' reliance on loans and increasing pressure on the Treasury. Dr. Michael Mumper of the State University of New York notes that the federal aid programs have made a significant contribution to higher education over the years, but they have also produced some discouraging results:

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[1] Michael Mumper, *Removing College Price Barriers* (New York: State University of New York Press, 1996).

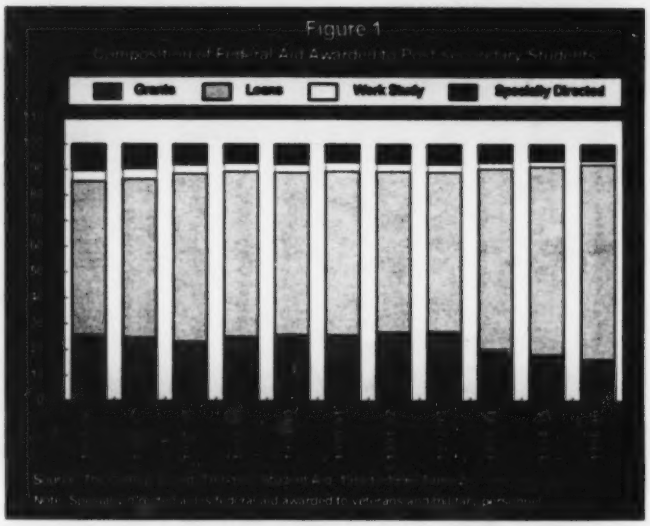
[2] The College Board, *Trends in Student Aid: 1986 to 1996*, September 1996, Table B.

[3] *Ibid.*

Since the early 1980s, the net price[4] of a college education has increased rapidly, the participation gap between upper- and lower-income students has expanded, and the focus of government subsidies has shifted from the most needy students to middle- and upper-income students. As a consequence, the goal of universal access to higher education is further away in the mid-1990s than it has been in more than a decade.[5]

Rising Tuition

The price of higher education has nearly doubled over the past 15 years and continues to rise. After adjusting for inflation, average undergraduate tuition at private institutions increased from $6,200 per year in 1980 to $11,800 per year in 1995; and average tuition at public institutions rose from approximately $1,100 per year to about $2,100 per year over the same time period. When the price for room and board is included, the average annual cost of attending private and public institutions in 1995 was $17,000 and $6,000 respectively.[6]



Shift in Federal Subsidies

As the cost of the student loan programs has increased, a larger percentage of government funding has been channeled toward loans for middle- and upper-income families, leaving less money to finance grants and other need-based programs for low-income families. Thus contrary to the original goals of the HEA, federal subsidies are now targeting middle- and upper- income students instead of disadvantaged students. Figure 1 and the accompanying table show that student loan programs are consuming

Table 1

Composition of Federal Aid Awarded to Post-Secondary Students

Academic Year	Grants	Loans	Work Study	Specially Directed
1985-86	25%	60%	4%	10%
1986-87	25%	62%	4%	10%
1987-88	23%	66%	3%	8%
1988-89	25%	64%	3%	8%
1989-90	26%	63%	3%	8%
1990-91	26%	64%	3%	7%
1991-92	27%	63%	3%	8%
1992-93	27%	62%	3%	8%
1993-94	20%	70%	2%	7%
1994-95	18%	73%	2%	7%
1995-96	16%	76%	2%	6%

Source: The College Board, *Trends in Student Aid: 1986 to 1996, Table 2.*
Note: Specially directed aid is federal aid awarded to veterans and military personnel.

[4] The difference between tuition and educational funds which do not have to be repaid such as scholarships or grants. This represents the amount the family must finance on its own.

[5] *Op. Cit., Removing College Price Barriers,* p. 215.

[6] U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics 1996* (Washington, DC: Government Printing Office, 1996), Table 309.

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an increasingly larger portion of federal funds at the expense of grants and work-study programs for the poor. Over the past decade, student loans as a percentage of all federal aid have increased by 27 percent while the share of grants has fallen by 36 percent.

Declining Affordability

Despite a 65 percent increase in government funding for student aid programs over the past 10 years, college has become less affordable for the most disadvantaged students. The combination of less government funding and higher tuition has greatly reduced the value of need-based programs. For example, the Pell Grant, which is the largest federal grant program for the poor, has declined considerably in value over the past decade.

Figure 2 shows that the value of the Pell Grant as a share of attendance costs has declined by 37 percent for public institutions and by 42 percent for private institutions. The Balanced Budget Act of 1997 includes funding to increase the value of the maximum Pell Grant from $2,700 to $3,000, but this increase will still leave Pell Grants grossly undervalued. As a result, many low-income families have found it necessary to take out loans for college. The prospect of incurring large debts has discouraged many low-income students from attending college altogether, thereby lowering the participation rates for low-income students relative to high-income students as shown in Table 2. In addition, the increase in student loan funding over the past 10 years does not necessarily reflect an increase in the well being of middle- and upper-income families since tuition increased by approximately 45 percent over the same time period.

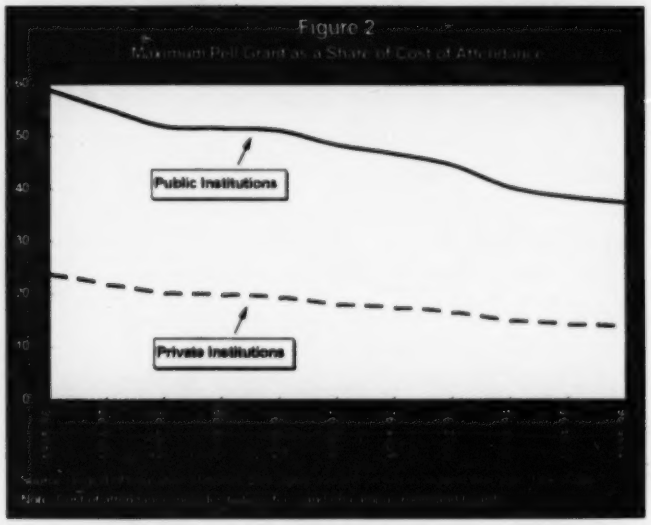


Table 2

Percent of Recent High School Graduates Enrolled in College by Family Income

October	Low	Medium	High
1980	32.5	42.7	65.2
1981	33.6	49.3	67.6
1982	32.8	41.7	71.7
1983	34.6	45.4	70.2
1984	34.5	48.4	74.0
1985	40.2	50.7	74.5
1986	33.9	48.4	71.4
1987	36.9	49.9	74.0
1988	42.5	54.7	72.8
1989	48.1	55.4	70.9
1990	46.7	54.5	76.5
1991	39.5	58.4	78.2
1992	40.9	56.9	80.9

Source: L. Gladieux and A. Hauptman, *The College Aid Quandry*, Table 5.
Note: Low income is defined as the bottom 20 percent of all family incomes, high income as the top 20 percent of all family incomes, and middle income as the 60 percent in between.

In brief, the federal aid programs, which were intended to equalize opportunities in higher education, have actually created a larger disparity over the past decade. Government inter-

vention has transformed the system into one heavily dependent on student debt, even for the most disadvantaged students. In addition, federal subsidies now target middle- and upper-income students contrary to the original intentions of the HEA.

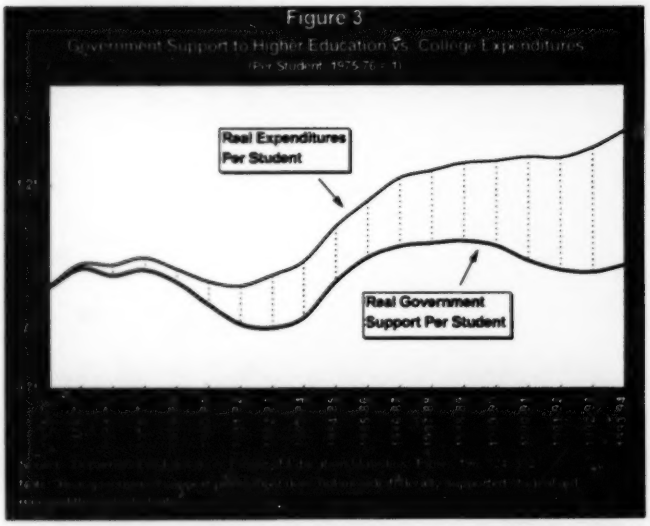
This transformation has mainly occurred because the structure of the federal aid system is inherently flawed and could be improved upon to provide greater benefits to students. Federal financing of higher education does not provide colleges with appropriate incentives to restrain spending and therefore encourages tuition hikes. The inefficient structure of student loan programs has broken down the marketplace for higher education by eroding price competition among schools and artificially inflating student demand. As a result, tuition continues to rise, college affordability continues to decline, and taxpayers continue to pay more for less valuable programs.

II. PROBLEMS WITH THE FEDERAL AID SYSTEM

Federal Aid and Tuition Inflation

The steep increase in tuition is largely attributable to a growth in college costs during the 1980s. College administrators contend that changing demographics in higher education since 1980 have necessitated an increase in costs in order to provide a high quality education to a more diverse student body. They argue that government appropriations to higher education did not keep pace with rising expenditures. As shown in Figure 3, government funding per full-time equivalent (FTE) student grew in pace with inflation between 1975 and 1993, but college spending per FTE student rose by 38 percent. College leaders argue that the government's failure to increase funding when costs were rising necessitated an increase in tuition to make up the shortfall.

Figure 3



However, many education experts believe that the fundamental problem in higher education is not a deficiency of government funding, but uncontrolled spending by colleges and universities.[7] They argue that, even though some of the increased spending may have been necessary due to the labor-intensive nature of higher education, a large part was unnecessary and extravagant. Much of the spending was merely an attempt by colleges to keep enrollment high in

[7] Thomas Sowell, *Inside American Education* (New York: The Free Press, A Division of Macmillan, Inc., 1993), pp. 113-121.

order to attract more state funding and did nothing to improve the quality of education. Thomas Sowell of the Hoover Institution at Stanford University notes that colleges and universities have expanded their bureaucracies, overseas facilities, and programs beyond what was needed to meet demand or improve educational quality.[8]

The evidence suggests that the structure of the federal aid system has contributed to the problem of uncontrolled costs and associated tuition hikes. Institutions generally base their spending decisions for the following year on the amount of revenue they project to earn in that year. The more money they expect to earn from various sources, the more spending they decide to undertake. The wide availability of federal aid thus encourages increased spending and subsequent tuition hikes.

Dr. Sowell provides the following example to illustrate this point: College X can charge $8,000 per student for tuition and cover its costs. The average family can afford $9,000 for tuition (based on a federal formula). If College X sets tuition at $8,000, it will receive no federal funding in the form of student aid. On the other hand, if College X sets tuition at $12,000, not only will it extract the additional $1,000 from the family, but it will also receive $3,000 of federal funds from each student. Thus, the school increases spending and justifies a tuition increase on the basis of rising costs. Classrooms remain full because the wide availability of student loans artificially inflates demand at any tuition price. This logic especially applies to private institutions because public institutions rely heavily on state funds and often face political pressure to hold down tuition.

Thus, the inherent problem with the federal aid system is that colleges and universities have little incentive to contain costs, boost productivity, or lower tuition. By increasing the availability of student aid and by making it easier to take out student loans, the government increases the stream of revenue available to institutions of higher education. Schools respond by increasing their expenditures and raising tuition to absorb the growing stream of revenues.

Past government efforts to improve college affordability have not addressed this problem. Instead of finding ways to fight tuition inflation, the government has simply made more federal funds available to more students so they can afford the higher tuition. Thus the benefits of additional federal subsidies are largely absorbed by schools, not students. An effective federal aid system must provide colleges with incentives to restrain costs and boost productivity so tuition can be kept from rising in the first place. Such incentives are grossly lacking from the current system.

Federal Aid and the Market for Higher Education

In general, industries which benefit from government subsidies are able to raise prices above their competitive levels. The same holds true in higher education—federal subsidies allow private colleges and universities to charge artificially high prices, thereby distorting the market for higher education and eroding price competition among schools. Dr. Sowell notes that "like

[8] *Ibid.*

monopolistic price discriminators in the commercial world, private colleges and universities set an unrealistically high list price and offer varying discounts. In academia, the list price is called tuition and the discount is called 'financial aid'."[9]

Institutions use a federal formula to determine the amount each family can reasonably pay for tuition. Then, by setting tuition at an artificially high level, institutions can charge each family the maximum amount it can afford and offer varying financial aid packages to supplement the remainder of the bill. In this way, universities and colleges can earn the greatest amount of revenue from each student. This practice of maximizing revenue by offering different customers different prices is referred to as "price discrimination." Perfect price discrimination is very difficult to practice in the business sector for at least two reasons. First, the product sold must be nontransferable or else customers who pay a low price can resell the product and steal high price customers away from the business. Second, to effectively price discriminate, companies need to know a good deal of information about each customer's willingness to pay for the product. In higher education, these two obstacles are largely overcome. Financial aid packages cannot be transferred among students and information about a family's financial resources is easily accessible from financial aid applications.

In sum, the wide availability of financial aid makes it easier for private colleges and universities to inflate their prices above the competitive level. In turn, easy access to financial aid also inflates the demand for higher education at any level of tuition. As a result, the entire market for higher education is inefficiently distorted.

Federal Family Education Loan (FFEL) Program

Guaranteed student loans, which are collectively known as the FFEL program, have provided important educational opportunities for millions of students. However, their structure is extremely inefficient so that a large portion of their economic benefit does not accrue to students. John Hood of the John Locke Foundation notes that in 1992, six million students received some form of federal aid at a cost of $11 billion to taxpayers. Of that $11 billion, $6 billion represented costs of subsidizing banks and paying for defaults.[10] Thus, over half of the benefit of federal subsidies did not go to students, but to middlemen. A different structure of providing financial resources could provide more assistance to more students in a more cost-effective manner.

The government subsidizes student loans to compensate lenders for the high risk associated with these loans, thus shifting the risk from private financial institutions to taxpayers. Under the FFEL program, the government pays the interest on student loans while a student is in school. The loans are then insured against default and guaranteed by the federal government. If a student defaults on a loan, the debt is turned over to a guarantee agency that fully compensates the lender. The guarantee agency, in turn, attempts to collect the overdue balance, but can be fully reimbursed by the government during its collection effort. The guarantee agency is entitled to a

[9] *Ibid.*, p. 120.

[10] John Hood, "How to Hold Down College Tuition Costs," *Consumers' Research*, October 1993.

100 percent reimbursement from the government and 30 percent of any funds it manages to recover. In 1991, guarantee agencies collected $200 million, or 13 percent of their total revenue, in this manner.[11] That same year, nearly one-fourth of all borrowers defaulted on their loans, costing taxpayers $3.6 billion.[12].

It is clear that guaranteed loans create perverse incentives for lending institutions and guarantee agencies. John Hood notes that "in virtually every instance, it pays for lenders and guaranty agencies to let students default—the former are fully reimbursed and save collection costs, while the latter are fully reimbursed and may even get back more than 100 percent of the value of the loan."[13] Consequently, a large percentage of federal expenditures is not transferred to students, but to middlemen who continue to profit handsomely at the expense of taxpayers who subsidize student loan defaults.

This system is extremely costly to students who do not receive the full economic benefit of government spending and to taxpayers who subsidize the profits of banks and guarantee agencies. Low-income students are disproportionately burdened because more money is diverted from need-based programs to finance the growing costs of the FFEL. In 1993, Congress enacted a direct lending program aimed at eliminating subsidies to middlemen. Direct lending allows the federal government to lend money directly to institutions that in turn distribute the money to students. Currently, the FFEL and direct lending program operate side by side, but it is too soon to judge the success of the new program.

III. TAX BENEFITS FOR HIGHER EDUCATION

Tuition Tax Credits

The cornerstone of the newly enacted education initiatives is a tuition tax credit called the HOPE Scholarship. The HOPE Scholarship provides families with a non-refundable tax credit of up to $1,500 against income tax liability for the first two years of post-secondary education. According to the U.S. Department of Treasury, the HOPE Scholarship will cost $35 billion over five years and $94 billion over 10 years. In addition, taxpayers will be allowed to claim a Lifetime Learning tax credit worth up to $1,000 for post-secondary education beyond the first two years.

The use of tuition tax credits to help families pay for college is similar to past government policies which have merely increased funding to pay for tuition without addressing the underlying problems of why tuition rises in the first place. As a result, the HOPE Scholarship may well contribute to the problems of the federal aid system instead of providing long-term solutions.

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[11] Thomas Toch, "Defaulting the Future," *U.S. News & World Report: Science and Society*, June 21, 1993.

[12] *Op. Cit.*, John Hood, "How to Hold Down College Tuition Costs."

[13] *Ibid.*

Rising Tuition

There is broad agreement that tuition tax credits would lead many post-secondary institutions to raise their prices. The effect would be most pronounced in public two-year institutions where average yearly tuition is $1,245. Since eligible families can claim up to $1,500 against their tax liability, the first $1,500 of education is essentially free. In other words, families are indifferent between paying $1,245 or $1,500--demand for a two-year college education is the same at either price. Thus, any public institution which charged less than $1,500 could increase its tuition without losing students or government funds.[14]

The availability of the tax credit will also affect tuition at private and public four-year institutions. Schools will realize that the tax credit increases a family's financial resources by $1,500. This will be taken into account when schools calculate a family's expected contribution. Once again, tuition will be set high enough to absorb the additional stream of revenues.

Affordability

The HOPE Scholarship is designed to primarily benefit middle- and upper-income families since the credit is not available to financially disadvantaged families with no income tax liability. As a result, the HOPE Scholarship probably will not encourage the enrollment of students who otherwise would not go to college. It is believed that the HOPE Scholarship will have two effects in the short run. First, it will allow students who are already bound for college to attend more expensive schools. Second, by increasing a family's after-tax income, it will reduce the amount of student loans for which families qualify.[15] In the long run, tuition tax credits will mainly generate large windfalls for institutions of higher education so that the benefit of this subsidy program will accrue to schools rather than to students.

In addition, the interaction between the HOPE Scholarship (and other newly enacted tax credits) and the alternative minimum tax (AMT) may substantially reduce the value of the credit for many middle-income families.[16] The AMT was designed to ensure that wealthy taxpayers, who shelter their incomes from taxation, pay a minimum amount of tax. The AMT requires that taxpayers first calculate their tax liability with all of their deductions and exemptions, then recalculate it using a complicated AMT formula. The individual must pay the greater of the two tax liabilities. Since the newly enacted tax credits, including the HOPE Scholarship, can reduce tax liability by a substantial amount, claiming the credits may subject many middle-income families to the AMT, thereby reducing the value of the tax credits. For instance, *The Washington Post* provides the following example: A family earning $64,100 per year with two children in college would normally pay $6,743 in taxes if filing jointly. If the family claims the HOPE credit for one child ($1,500) and the Lifetime Learning credit ($1,000) for the other, their tax

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[14] Joint Committee on Taxation, "Analysis of Proposed Tax and Saving Incentives for Higher Education," April 15, 1997.

[15] Jane Bryant Quinn, "New Tax Credits May Bring Cuts in Student Aid," *The Washington Post (Business)*, August 31, 1997.

[16] Albert B. Crenshaw, "Now You See It, Now You Don't: Tax Law to Make Benefits Disappear," *The Washington Post (Business)*, September 17, 1997.

liability would be reduced to $4,243. However, under the AMT calculation, the family's tax liability is $4,966. Since the AMT is the greater of the two amounts, the family must pay the AMT, thus reducing the value of the HOPE Scholarship by $723. According to the minority staff of the House Ways and Means Committee, this interaction may affect a substantial number of middle-income taxpayers with incomes as low as $41,350. Thus, because the tax credits were not designed to offset the AMT, many middle-income families will be subjected to this upper-income tax. As a result, many middle-income families will not receive the full benefit of the HOPE Scholarship, even in the short run.

In sum, tuition tax credits are similar to past government policies which simply provide more aid instead of providing colleges with incentives to control costs and tuition inflation. In fact, the Administration does not believe that cost containment is a reasonable objective. At a Brookings Institution conference on higher education, David Longanecker of the Department of Education (DOE) "made it clear that the Clinton Administration does not see tuition growth and cost containment as a federal responsibility."[17] Instead, it is an issue for states and trustees. Thus, the Administration feels that college affordability is a federal responsibility, but the root of the problem is not.

Expansion of IRAs

The current financial aid system may discourage parents from saving for education because a family's savings can reduce a student's eligibility for grants and scholarships. Families whose financial assistance is reduced based on their level of savings thus face an implicit tax. As a result, many parents save too little for their children's education.

The Balanced Budget Act of 1997 includes several incentives aimed at increasing private saving for education. The new law gradually doubles the income limits for which tax deductible contributions to IRAs are phased out, making IRA saving plans available to more middle-income families. In addition, penalty-free withdrawals will be allowed to pay for higher educational expenses. Parents will also be able to contribute $500 per child, per year to separate education IRAs. Contributions to education IRAs will be nondeductible, but distributions will not be subject to taxation.[18] These new IRA rules will allow families to accumulate tax-free savings for educational expenditures, thus encouraging families to save for their children's education.

Enhanced saving incentives can help improve college affordability. Dr. Mumper states that "...there is powerful theoretical and anecdotal evidence that a soundly designed and broadly accessible program to encourage college savings can be a useful part of a comprehensive

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[17] Lawrence Gladieux and Arthur Hauptman, *The College Aid Quandary* (Washington, DC: The Brookings Institution, 1995), p. 62.

[18] Retirement IRAs are front-loaded; meaning that taxpayers can exclude IRA contributions from income when calculating their income tax liability. However, distributions from the IRA are subject to taxation. In contrast, education IRAs will be back-loaded; meaning that contributions are not tax deductible, but distributions are not subject to taxation. In general, the two types of IRAs are equivalent unless the taxpayer moves into a different tax bracket between the time the contribution is made and the time the distribution is withdrawn.

government effort to improve college affordability."[19] By reducing families' reliance on student loans and allowing them the opportunity to finance educational expenses from their own financial resources, expanded IRAs can restore price competition to the marketplace for higher education and reduce government costs. Government savings can then be diverted to federal grants to help equalize opportunities for financially disadvantaged students.

Maximizing Educational Return

Expanded IRAs will provide families with opportunities to reduce their tax liabilities and accumulate enough savings to pay for a substantial amount, if not all, of their children's education. Families who use their own financial assets to pay for higher education, rather than borrowed federal funds, will be encouraged to make more responsible decisions regarding where their children go to school and what programs they enter. John Hood points out that no mechanism exists today to make sure children are attending schools with a good money's worth and entering programs that will likely land them a job after they graduate.[20] Thus unwise decisions are made which are costly to students and taxpayers.

For instance, DOE reported that 200,000 students enroll in beauty school each year despite an oversupply of one million cosmetologists nationally. Many beauty school students drop out or cannot find jobs when they graduate, thus failing to repay $100 million worth of loans each year. Consequently, taxpayers spend about $31,000 in student aid for every cosmetology license that is issued in the United States.[21]

Subsidizing the Poor

The most commonly cited criticism against expanded IRAs for education is that low-income families would not be able to participate since they do not have enough financial resources to save, and they do not have any income tax liability from which contributions can be deducted. However, expanded IRAs can reduce the cost of the federal aid programs by making middle- and upper-income families less reliant on student loans. This in turn would allow federal funds to target low-income families through more valuable grants and work-study programs as originally intended by the HEA. Thus middle- and high-income students can benefit because they will be able to graduate with less debt; low-income students will benefit because federal subsidies can be redirected to need-based programs.

Cost Containment and Tuition

With families more reliant on personal financial assets, the government can reduce the size of the student loan programs by awarding student loans on the basis of financial need or academic merit. This could create three desirable effects. First, the reduction in the availability of "easy money" would deflate the artificially high demand for post-secondary education that

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[19] *Op. Cit., Removing College Price Barriers*, p. 186.

[20] *Op. Cit., How to Hold Down College Tuition Costs.*

[21] *Op. Cit., Defaulting the Future.*

now exists. If families rely on their own financial resources for the bulk of educational expenses, then demand should fall in line with what the free market would dictate.

Second, reduced reliance on financial aid would undermine a school's ability to price discriminate since financial aid could not easily supplement a family's expected contribution. As mentioned earlier, private schools can easily raise tuition because tuition hikes are met with more financial aid. If financial aid is limited, then schools would truly have to compete for private assets, giving them incentives to provide a high quality education at a low cost.

Third, linking financial aid to academic merit would motivate children to work harder during high school. Tuition tax credits, on the other hand, make two years of higher education a universal right for all students, thereby reducing students' incentives to do well in high school.

Expanded IRAs will provide families with appropriate incentives and opportunities to accumulate enough private savings to afford their children's education. As families become financially independent, they will grow less reliant on student loans, thus reducing the cost and size of the federal aid system. Government savings can be partially used to restore the value of need-based programs for low-income students. The reduction in federal subsidies would restore competitive pressures to the marketplace for higher education, giving institutions an incentive to control costs, improve productivity, and contain tuition. Thus expanded IRAs can help improve college affordability.

IV. ECONOMIC BENEFITS OF IRAS

Benefits for Taxpayers

In addition to the benefits provided for education, expanded IRA incentives can generate other benefits for American families as well. In general, IRAs provide three important tax benefits. First, front-loaded IRAs allow taxpayers to deduct IRA contributions from income, thereby lowering income tax liability for the year in which the contribution is made. Second, IRAs allow families to defer their taxes to a time when their marginal tax rate may be lower. Families can deduct their contributions when they fall within a high tax bracket and withdraw the funds at a time when they fall within a lower tax bracket. Third, income earned in the account (inside build up) is not taxed.

In addition, IRA investments can yield higher returns than tax-free investments. Normally, tax-free investments, such as municipal bonds, yield lower rates of return than investments that are subject to taxation. Consequently, a family will not necessarily increase its after-tax rate of return by investing in tax-free investments. However, savings in IRAs can be invested in a wide range of assets including otherwise taxable assets with higher yields. Thus the family receives the tax benefit offered by the IRA and the higher yield offered by a taxable investment. As a result, the family can earn a higher rate of return on an IRA investment than what could be earned from a tax-free non-IRA investment.

The new tax legislation has made important progress in the expansion of IRAs by making IRAs available to more middle-income families and by providing saving incentives for higher education. However, it falls short in three respects. First, the contribution limit of $2,000 per year is too low to provide families with appropriate opportunities to amass a significant amount of savings. The maximum contribution must be raised to provide families with incentives to substantially increase their personal savings.

Second, studies have shown that many individuals do not participate in IRAs because of the restrictions on IRA distributions. Distributions from retirement IRAs are subject to a penalty if withdrawn before the age of 59½. Penalty-free withdrawals should be allowed for a variety of purposes to encourage families to participate in IRA saving.

Third, the new law creates several different types of IRAs for different purposes, thus complicating the tax code. Families who want to take advantage of IRA benefits will have to determine which IRA saving plan is best for them and many may have to seek professional assistance. The added complication may discourage some families from participating in IRA saving altogether.

If the contribution limit were raised above $2,000 and penalty-free withdrawals were allowed for a wider variety of expenses, then traditional retirement IRAs can potentially become an important saving vehicle for middle-income families. Such expansions would allow families to accumulate a significant amount of savings to finance retirement, educational expenses, and other important expenses a family might incur. Thus taxpayers could become financially independent and less reliant on the federal safety net. In addition, since individuals are generally the best investors of their own money, expanded IRAs can allow families to increase their incomes beyond what the government can provide for them through bloated, inefficient federal programs.

Benefits for the Economy

Expansion of IRA benefits can promote economic growth through its impact on saving and investment. Investment is important to the economy because it increases the domestic stock of capital, thereby promoting economic growth and productivity improvements. A larger, more productive economy generates new jobs, higher wages, and better living standards.

Investors have two sources of funds available to them: national saving (the sum of private and government savings) and foreign saving. If national saving falls short of investment demand, investors can borrow funds from foreign sources. Thus the availability of foreign funds allows investment to increase even if national saving is low. However, reliance on foreign saving can create three undesirable effects. First, the profits from the investment flow overseas. Second, the debt must be repaid with interest so that the net wealth inherited by future generations is lower than it otherwise would be. Third, when investment demand exceeds national saving, there is upward pressure on interest rates. Thus, a high national saving rate is desirable because it reduces investors' reliance on foreign money.

However, many economists argue that the national saving rate in the United States is too low because the tax code discourages private saving and encourages consumption. For instance, savings are subject to several levels of taxation, but consumption of certain products is rewarded through tax credits and deductions. The expansion of IRAs clearly helps reduce this bias by providing taxpayers with incentives to save. Expansion of IRAs thus promotes economic growth by increasing saving and investment.

There are some analysts who dispute the economic benefits of IRAs. According to these analysts, IRAs do not attract new saving, they merely encourage taxpayers to shift their existing savings into IRA investments. To the extent that net saving does not increase, the effects of IRAs on the economy are limited.

The empirical studies on IRA saving effects have produced mixed results. However, many notable studies conclude that IRAs do in fact represent new saving. Some of the most distinguished studies have been conducted over the past several years by James Poterba of M.I.T., Steven Venti of Dartmouth College, and David Wise of Harvard University.

Poterba, Venti, and Wise (PVW) point out that the key obstacle to determining the saving effect of IRAs is saver heterogeneity. In other words, some people save and others do not--those who are inclined to saving tend to save more in all forms. For example, families with IRAs have more conventional savings than families without IRAs. Controlling for heterogeneity is extremely important in determining whether IRA contributions increase net saving. PVW use several different methods to control for heterogeneity which they believe sufficiently address the problems presented by this issue. They conclude that "the weight of the evidence, based on many non-parametric approaches...provides strong support for the view that contributions to both IRA and 401(k) plans represent largely new saving...We believe the evidence is strong in all cases"[22]

They note that several other studies using different methods have arrived at different conclusions. The most commonly cited study indicating that IRAs have no saving effect was conducted by Gale and Scholz (GS) in 1994. PVW reviewed the analysis used in this 1994 study and found that "their conclusions are inconsistent with the raw data and their formal model does not provide reliable information on the extent of substitution."[23] In specific, to estimate their model, GS deleted a large number of observations from their sample data. Although there is nothing wrong with deleting observations from the data, PVW show that the estimates in the GS study are extremely sensitive to exactly which observations are deleted and "the deletions that were made essentially determine the conclusions that GS report."[24] In addition, PVW point out that other limitations of the methodology used by GS seriously undermine the reliability of the GS study.

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[22] James Poterba, Steven Venti, and David Wise, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence," *National Bureau of Economic Research*, May 1996, p. 94.

[23] *Ibid.*

[24] *Ibid.*

The PVW study provides compelling evidence that IRA contributions do in fact represent an increase in new saving. Consequently, their expansion should generate important benefits for the economy.

V. CONCLUSION

Although the federal aid system has helped millions of students over the years, it has also contributed to some discouraging trends: tuition is rising, federal subsidies are shifting away from low-income students, and the value of need-based programs for the poor is declining.

These trends have occurred because the federal aid system is inherently flawed and could be improved upon to provide greater benefits to students. Federal financing of higher education does not provide colleges with incentives to restrain costs, and therefore encourages tuition hikes. The inefficient structure of student loans has broken down the marketplace for higher education by eroding price competition among schools and artificially inflating student demand. Past legislation to improve college affordability has simply increased the funding available to students instead of addressing the fundamental problems of cost containment and tuition inflation. As a result, increased federal subsidies have not necessarily improved the well being of student loan recipients. Students would benefit from alternative policies that expand educational opportunities in a more efficient and cost-effective manner.

The HOPE Scholarship recently enacted into law will not improve college affordability because it fails to address the core problems of the federal aid system. Instead, tuition tax credits will only create windfalls for colleges that adjust their tuition upward to absorb the additional revenue.

A more effective solution may be the expansion of IRAs which provide families with incentives to increase their savings for education. By reducing families' reliance on student loans and allowing them the opportunity to finance educational expenses from their own financial resources, expanded IRAs can restore price competition to the marketplace for higher education and provide colleges with incentives to reduce costs, contain tuition, and improve quality. Furthermore, reduced reliance on student loans can lower government costs, allowing the savings to be diverted to federal grants for the poor. Although the IRA expansion provisions contained in the new law are limited, there is evidence to suggest that more aggressive expansion could provide more significant benefits for families and the economy.

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